Office-Supreme Court, U.S.
FILED
JUL 8 1981
ALEXANDER L. STEVAS,
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81-99

No. ....
IN THE

Supreme Court of the United States

October Term 1981

AARON L. KOLOM and SERITA KOLOM,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Questions Presented for Review.

1. Whether for purposes of the minimum tax on tax preferences imposed by Sections 56 and 57 of the Internal Revenue Code, the "fair market value" of a share of stock transferred pursuant to the exercise of a qualified stock option must be determined by taking into account the impact of Section 16(b) of the Securities Exchange Act of 1934 on the recipient of the shares.

2. Whether the incorporation of Section 83 of the Internal Revenue Code into Section 57(a)(6) of the Internal Revenue Code by Treasury Regulations Section 1.57-1(f)(3) is invalid.

3. Whether Treasury Regulations Section 1.57-1(f)(3) establishes an irrebuttable presumption as to the value of stock transferred in return for services that violates the Due Process Clause of the Fifth Amendment to the Constitution.

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

The Petitioners, Aaron L. Kolom and Serita Kolom, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered on April 9, 1981.

Opinions Below.

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 644 F.2d 1282. The opinion of the United States Tax Court is reported at 71 T.C. 235. These opinions are reprinted in Appendices A and B, pp. 1-40.

Jurisdiction.

The decision of the Tax Court was entered on November 21, 1978. The judgment and opinion of the Court of Appeals affirming the decision was entered on April 9, 1981. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Statement of the Case.

In 1968, 1970 and 1971, Petitioner Aaron L. Kolom ("Kolom") was granted options to acquire Tool Research and Engineering Corporation ("TRE") stock pursuant to the TRE Employees' Stock Option Plan ("Plan"). The Plan met the qualification requirements of Sections 421 and 422 of the Internal Revenue Code of 1954, as amended. All of Kolom's options were exercised in September and October 1972 when Kolom was an officer and director of TRE.

Kolom's option exercise prices for the three blocks of stock were 13¼, 12 and 19⅝; the mean price per share of TRE stock on the New York Stock Exchange ("NYSE Price") on the dates of exercise were, respectively, 51⅛, 44 and 44. However, because of Kolom's status as a TRE officer and director, the stock had no practical liquidity at time of exercise. Pursuant to Section 16(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78p(b)],* as interpreted by Securities and Exchange Commission Rule 16b-6 [17 C.F.R. §240.16b-6 (1980)], if Kolom sold a share of stock acquired pursuant to the exercise of the options within six months of its purchase, the amount by which the sales price exceeded the greater of (a) the option exercise price and (b) the lowest market price of the stock within six months before or after the date of sale would "inure to and be recoverable by" TRE. Testimony in the Tax Court established that the watch dog function played by the plaintiff's bar would assure automatic repayment of such amount to TRE.

Six months after the date of exercise of the first block of stock, the NYSE Price of the stock had dropped over

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*All references herein to Section 16(b) are to Section 16(b) of the Securities Exchange Act of 1934. All other section references are to the Internal Revenue Code, unless otherwise indicated.

50%, to 23⅝. Six months after the date of exercise of the last two blocks of stock, the NYSE Price of the stock had also dropped over 50%, to 20⅛. Kolom eventually sold 5,000 shares of the stock purchased upon exercise of the options for an average price of $9.27 a share, realizing a substantial loss on the transaction.

During the year 1972, Sections 56 and 57 imposed a tax on items of "tax preference" in excess of certain amounts. The definition of items of tax preference included the following at Section 57(a)(6):

> Stock Options—With respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option (as defined in section 422(b)) or a restricted stock option (as defined in section 424(b)), the amount by which the fair market value of the share at the time of exercise exceeds the option price.

Proposed Treasury Regulations Section 1.57-1(f)(3) provided on the date of exercise of the option that, "[t]he fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined . . . consistent with the principles applicable under section 83(a)(1) and the regulations thereunder." Appendix J, p. 48.

Section 83(a)(1) provides that fair market value shall be "(determined without regard to any restriction other than a restriction which by its terms will never lapse) . . . ." Appendix F, p. 44. However, Section 83(e)(1) provides that "[t]his section shall not apply to . . . a transaction to which section 421 applies . . . ." Appendix G, p. 45. Kolom's stock options were qualified options to which Section 421 applied. See Appendix H, p. 46.

The joint return for 1972 filed by Kolom and Petitioner Serita Kolom did not report any liability for minimum tax under Sections 56 and 57 with respect to the exercise of the

qualified stock options. The Petitioners fully disclosed the exercise of their stock options on an attachment to the return and indicated that the Petitioners did not regard minimum tax as due as they could not sell the the acquired stock in the year the option was exercised because all profits would belong to TRE.

The 1972 return filed by Petitioners was audited by the Internal Revenue Service and no adjustment was made with respect to minimum tax liabilities. Subsequently, as a result of an audit of TRE's returns and information given to the auditing agent by Kolom, Petitioners' 1972 return was reopened on the minimum tax issue. On March 30, 1976, the Commissioner of Internal Revenue (the "Commissioner") issued a notice of deficiency to the Petitioners asserting a Federal income tax deficiency of $42,489.00 for the tax year ended 1972 based on the imposition of the minimum tax pursuant to Sections 56 and 57 on the aggregate amounts by which the closing price of TRE stock on the dates of exercise of the options exceeded the option exercise prices.

The Petitioners timely filed a Petition in the United States Tax Court asserting that the determination of tax as set forth in the notice of deficiency was in error. Jurisdiction was conferred on the Tax Court by Sections 7442 and 6213 of the Internal Revenue Code. Subsequently, the Commissioner's answer was amended to increase the deficiency for the taxable year 1972 to $43,792.00 reflecting the mean prices instead of the closing prices on the New York Stock Exchange on the dates the options were exercised. A stipulation of facts was jointly submitted to the Tax Court by the Petitioners and the Commissioner on September 27, 1977 and the case was tried on that same day.

The Tax Court upheld the deficiency in a decision reported at 71 T.C. 235. A timely notice of appeal was filed on January 26, 1979 with the United States Court of Appeals

for the Ninth Circuit. Jurisdiction was conferred on the Court of Appeals by Section 7482 of the Internal Revenue Code. In an opinion dated April 9, 1981 the Court of Appeals affirmed the decision of the Tax Court. The Court of Appeals' decision is reported at 644 F.2d 1282.

Both the Tax Court and the Court of Appeals held that, for purposes of Sections 56 and 57, the fair market value of the stock received by the Petitioners pursuant to the exercise of the qualified stock options could be determined without reference to the impact of Section 16(b) on the value of such stock to the Petitioners. Both courts also found that Treasury Regulations Section 1.57-1(f)(3) is valid and constitutional in its application of the principles of Section 83 to the determination of the fair market value of stock under Sections 56 and 57.

REASONS FOR GRANTING THE WRIT.

I.

The Opinion Below Creates a Conflict Among the Circuits as to Whether the "Fair Market Value" of Stock Received Through Exercise of a Stock Option May Be Determined Without Taking Into Account the Impact on the Recipient of Section 16(b).

In holding that the "fair market value" of the stock acquired pursuant to the exercise of the qualified stock options may be determined without reference to the impact of Section 16(b) on the Petitioners, the Ninth Circuit has placed itself in conflict with the Seventh Circuit's earlier decision in *MacDonald v. Commissioner*, 230 F.2d 534 (7th Cir. 1956).

In *MacDonald*, as in the present case, the issue before the court was whether the "fair market value" of stock received pursuant to the exercise of a stock option should be calculated in such a way as to reflect the impact of Section 16(b) on the recipient of the stock. The taxpayer in *MacDonald* was an officer of a corporation who had been granted an option for 10,000 shares of company stock; at the time that the taxpayer exercised the option the difference between his option price and the New York Stock Exchange price amounted to $15.05 a share. Because of his exposure to Section 16(b) on any short term sale of the stock, and because of an alleged oral agreement restricting the sale of the stock, the taxpayer argued that no income had been realized on the exercise of the option. The Service contended that the taxpayer had received income in an amount equal to $15.05 per share of acquired stock and the Tax Court agreed.

The Seventh Circuit agreed with the Tax Court that the taxpayer had realized income, but did not agree that the amount of income could be measured with reference to the

price of the shares on the New York Stock Exchange. In reversing the Tax Court on this latter point, the Seventh Circuit held that, while the New York Stock Exchange price reflected the "fair market value" of the stock to other individuals, it did not reflect the "fair market value" of the stock to an individual who because of Section 16(b) could not profit from any short term fluctuation in market price. The Seventh Circuit then remanded the matter to the Tax Court for determination of the proper amount of discount required to reflect the impact of Section 16(b) on "short-swing" insider profits.

In ruling that the determination of the "fair market value" of a financial instrument must take into account restrictions which affect the class of persons to which the taxpayer belongs, the court in *MacDonald* accurately anticipated the position taken by this Court in *United States v. Cartwright*, 411 U.S. 546 (1973). In that case, the Court held that the determination of the "fair market value" of shares of a mutual fund must be made with reference to restrictions affecting the taxpayer's ability to realize income from such shares. This Court ruled that the "fair market value" of those shares was not the price of such shares on the open market, but the amount the taxpayer could have realized on resale of the shares. Indeed, the proposition that the "fair market value" of a financial instrument is to be determined in light of all relevant limitations on that instrument has been the conclusion of a considerable number of individual courts, both before and after this Court's decision in *Cartwright*. *See, e.g., Mailloux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963) (contractual restriction on resale of stock); *Bankers Trust Company v. United States*, 284 F.2d 537 (2d Cir. 1960) (bonds worth more to estate than to market); *Cohu v. Commissioner*, 8 T.C. 796 (1947) (resale restrictions on shares); *Goldwasser v. Commissioner*, 47 B.T.A.

445 (1942), *aff'd*, 142 F.2d 556 (2d Cir. 1944), *cert. denied*, 323 U.S. 765 (1944) (contractual restriction on resale of stock).

It is especially appropriate to take the impact of Section 16(b) into account in Petitioners' case since the value to an employee of the compensation bargained for in the form of stock is clearly adversely affected by the practical limitation on liquidity represented by Section 16(b). That the relevant market for determining the value of compensatory transfers of property is the market that exists between employer and employee for services is acknowledged by the concurring judge in the Tax Court below:

> A share of stock awarded as compensation to a person who is subject to a legal requirement that he must disgorge any gains on a sale thereof within 6 months obviously provides significantly less compensation to him than would an otherwise identical share awarded to a person not so subject.

Appendix B, p. 39.

The opinion below attempts to distinguish *MacDonald* on the ground that, in *MacDonald*, "[t]he court specifically stated that it was not deciding whether section 16(b) had an effect on the fair market value of the stock at the time the option was exercised." Appendix A, p. 14. The attempted distinction is without merit. Although the court in *MacDonald* did not attempt to determine the *extent* to which Section 16(b) influenced the "fair market value" of the shares, its reversal of the Tax Court was based on its conclusion that the combined effect of Section 16(b) and the alleged oral restriction on resale did indeed affect the "fair market value" of the shares. The court explained its position as follows:

> Taxpayer acquired the corporate stock with an agreement not to sell and, in addition, if he had violated this

> agreement and sold the stock, he probably would have been required to account for the profits. Certainly he would have been faced with a legal action to recover such profits. This is not to say that he did not realize economic gain upon the purchase of the stock but, even so, the question remains as to the proper formula for the ascertainment of the amount and extent of such gain. The Tax Court has held that it is the difference between the option price and the market value of the stock on the New York Stock Exchange at the time of its acquirement. We disagree with that conclusion.

230 F.2d at 54.

The opinion below attempts to distinguish *Mailloux*, *Cohu* and *Goldwasser* by the alleged breadth of restrictions considered therein, taking the position that such cases require "fair market value" determinations to take into account only restrictions which limit the taxpayer from selling or transferring the property on the open market. Since the property in the instant case is technically transferable, the opinion below finds the holdings in *Mailloux*, *Cohu* and *Goldwasser* inapplicable. Appendix A, p. 13.

Again, the attempted distinction is without merit. While *Mailloux*, *Cohu* and *Goldwasser* deal with limitations on transferability, other cases, including *Bankers Trust Company*, deal with restrictions which do not prevent transferability, and affect only a class of persons to which the taxpayer belongs. In *Bankers Trust Company*, for example, the Second Circuit was faced with the task of valuing "flower" bonds for purposes of calculating the decedent's estate tax liability. The bonds were freely transferable and salable on the open market. Nonetheless, the court there held that the "fair market value" of the bonds should be determined with reference to the specific class of persons

(death beneficiaries) to which the taxpayer belonged, and not with reference to the open market.

In sum, the opinion below directly conflicts with the Seventh Circuit's decision in *MacDonald* as to the impact of Section 16(b) on "fair maket value" determinations. That conflict has now been heightened by the recent case of *Harrison v. United States*, 475 F. Supp. 408 (E.D.Pa. 1979), *aff'd*, 620 F.2d 288 (3rd Cir. 1980). On substantially the same facts as the instant case, the district court in *Harrison* cited the opinion below as authority in holding that Section 16(b) does not affect the "fair market value" of stock received pursuant to exercise of a qualified stock option. The Third Circuit affirmed that decision without discussion. Thus, the Court now faces a situation where the Ninth and the Third Circuits are in conflict with the Seventh Circuit as to whether the "fair market value" of stock may be determined without considering the effect on the stockholder of Section 16(b).

II.

The Court Below Erred in Holding Valid Treasury Regulations That Apply the Fair Market Value Principles of Section 83 to Section 57(a)(6) in the Face of Inconsistent Statutory Language and a Direct Statutory Prohibition.

Section 56 imposes a minimum tax on certain items of "tax preference." Appendix D, p. 42. Section 57(a)(6) defines as a tax preference for purposes of the minimum tax the amount by which the "fair market value" of a share of stock transferred pursuant to the exercise of a qualified stock option at the time of such exercise exceeds the option price. Appendix E, p. 43.

Section 83(a)(1) provides that for purposes of determining the amount of gross income realized upon a transfer of

property in compensation for services, fair market value is to be "(determined without regard to any restriction other than a restriction that by its terms will never lapse), ..." Appendix F, p. 44. Treasury Regulations Section 1.83-3(h) provides in applicable part that "[l]imitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions." Section 83(e)(1), however, expressly states that Section 83 shall not apply to "a transaction to which Section 421 applies . . . ." Appendix G, p. 45. Section 421 is the operative provision that sets out the consequences of the grant and exercise of a qualified stock option such as those exercised by Petitioner Kolom. Appendix H, p. 46.

Sections 57(a)(6), 83(a)(1) and 83(e) were all enacted simultaneously by the Tax Reform Act of 1969, Pub.L. 91-172. In Section 57(a)(6) Congress used only the term "fair market value" to describe the basis for the measure of minimum tax while in Section 83(a)(1) Congress chose to modify the term fair market value by requiring that "lapse" restrictions be ignored as a factor in its determination. Not only did Congress use different statutory language in describing the principles to be applied in determining fair market value under the two sections, but in Section 83(e)(1) Congress also expressly prohibited application of Section 83's more limited definition of fair market value to transactions involving qualified stock options.

Despite the clear intention of Congress, both express and implied, in Treasury Regulations Section 1.57-1(f)(3) the Treasury Department attempted by regulatory fiat to treat the distinctions between the two sections as non-existent and to ignore the statutory prohibition of Section 83(e)(1). The regulation as finally adopted and as applied in this case

simply and boldly states that, in the context of Section 57(a)(6), "[i]n accordance with the principles of Section 83(a)(1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined without regard to restrictions (other than non-lapse restrictions . . .)." Appendix K, p. 49.

The courts below held that Section 83(e)(1) merely solves the conflict that would otherwise arise between the current taxation required by Section 83 on the exercise of stock options and the deferred taxation provided for by Section 421. The courts below further concluded that as the Treasury Regulation merely used Section 83 principles for valuation purposes and not to provide for inclusion of the value of stock in income, the Treasury Regulations were not inconsistent with Section 83(e)(1). Appendices A, pp. 9-10 and B, p. 27. However, to the extent that the valuation principles of Section 83 result in a higher, artificial fair market value for Petitioners' stock, they do result in an increase in tax on transactions subject to Section 421 and violate the direct prohibition of Section 83(e)(1).

In general, a Treasury Regulation may be invalidated only if it is unreasonable and clearly inconsistent with the statute. *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 488 (1979). Nonetheless, where a regulation is unreasonable, this Court does not extend the Treasury unfettered authority and has not hesitated to invalidate Treasury Regulations:

> [I]t does not follow that, because [the Commissioner] has a choice of alternatives, his choice should be sustained where the alternative chosen is unrealistic. In such a situation the regulations embodying that choice should be held to be unreasonable . . . .

United States v. Cartwright, 411 U.S. 546, 557 (1973) (citations omitted).

Section 16(b) had a direct and adverse impact on the fair market value of stock transferred to the Petitioners. Under the clear statutory language the measure of the minimum tax imposed on Petitioners should reflect the impact of Section 16(b) and the attempt by the Treasury to incorporate Section 83 valuation principles into Section 57(a)(6) should be found invalid. By upholding the validity of the regulation, the court below has created a serious federal question of statutory construction that should be resolved by this Court.

III.

As Applied by the Court Below the Artificial and Arbitrary Definition of Fair Market Value Incorporated Into Section 57(a)(6) by the Treasury Regulations Creates an Irrebuttable Presumption That Violates the Due Process Clause of the Fifth Amendment to the Constitution.

The substance and impact of the definition of fair market value set forth in Section 83(a)(1) is substantially the same as a conclusive presumption of value. *Miriam Sakol v. Commissioner*, 67 T.C. 986, 992 (1977), *aff'd*, 574 F.2d 694 (2d Cir. 1978), *cert. denied*, 439 U.S. 859 (1978). The conclusive value irrebuttably presumed by Section 83(a)(1), however, is inconsistent with true fair market value as affected by the limitations on retention of profit imposed by Section 16(b). Consequently, the Treasury Regulations' application to the Petitioners of the artificial and irrebuttable fair market value standard of Section 83(a)(1) has deprived them of their property in violation of the Due Process Clause of the Fifth Amendment to the Constitution by imposing an income tax measured in part by an amount which has no economic benefit to Petitioners.

This result is in direct conflict with the long-established principle enunciated by this Court in *Heiner v. Donnan*, 285 U.S. 12 (1932); *Hoeper v. Tax Commission*, 284 U.S. 206 (1931); and *Schlesinger v. Wisconsin*, 270 U.S. 230 (1926), that a statute which imposes a tax on an amount which provides no economic benefit to the taxpayer based upon an assumption of fact which the taxpayer is forbidden to controvert is so arbitrary and unreasonable that it cannot stand under the Due Process Clause.

In *Schlesinger v. Wisconsin*, the petitioner challenged a Wisconsin statute that provided that every gift of a material part of a decedent's estate made by him within six years of death "shall be construed to have been made in contemplation of death" (270 U.S. at 236) for death tax purposes. This Court held that the statute established an invalid conclusive presumption and declared it to be in violation of the Due Process and Equal Protection Clauses. In *Heiner v. Donnan*, this Court considered a challenge to the constitutionality of a similar federal estate tax statute (Section 302(c) of the Revenue Act of 1926) providing that gifts made within two years of death of the donor shall "be deemed and held to have been made in contemplation of death" (285 U.S. at 320). In ruling the statute unconstitutional this Court held that the conclusive presumption established by the statute "constitutes an attempt, by legislative fiat, to enact into existence a fact which here does not, and cannot be made to exist in actuality" (285 U.S. at 329). In *Hoeper v. Tax Commission*, a Wisconsin statute measured a husband's income with reference to his wife's income for state income tax purposes. Under Wisconsin law a married woman's earnings were her separate property. This Court struck down the state income tax statute which measured an income tax on an amount that was not an economic benefit to the taxpayer. A tax statute which, in

effect, presumed a fictitious amount to be an economic benefit was held to violate due process.

This Court has recently approved the rationale of these three tax cases in *Vlandis v. Kline*, 412 U.S. 441, 446 (1973). *See also Cleveland Bd. of Educ. v. LaFleur*, 414 U.S. 632, 644 (1974); *U.S. Dept. of Agriculture v. Murry*, 413 U.S. 508, 512 (1973); and *Stanley v. Illinois*, 405 U.S. 645 (1972). In *Vlandis v. Kline* the Court made the following statement:

> Statutes creating permanent irrebuttable presumptions have long been disfavored under the Due Process Clause of the Fifth and Fourteenth Amendments. In *Heiner v. Donnan*, 285 U.S. 312 (1932), the Court was faced with a constitutional challenge to a federal statute that created a conclusive presumption that gifts made within two years prior to the donor's death were made in contemplation of death, thus requiring payment by his estate of a higher tax. In holding that this irrefutable assumption was so arbitrary and unreasonable as to deprive the taxpayer of his property without due process of law, the Court stated that it had "held more than once that a statute creating a presumption which operates to deny a fair opportunity to rebut it violates the due process clause of the Fourteenth Amendment." *Id.*, at 329, see, *e.g.*, *Schlesinger v. Wisconsin*, 270 U.S. 230 (1926); *Hoeper v. Tax Comm'n*, 284 U.S. 206 (1931).

412 U.S. at 446.

This Court's opinion in *Weinberger v. Salfi*, 422 U.S. 749 (1975), has been cited in support of the assertion that the broad scope of the irrebuttable presumption doctrine evidenced in *Vlandis* and *Donnan* has been narrowed to a test based only on a rational nexus between the criteria set forth in the statutory mandate and a legitimate congressional purpose. *Sakol v. Commissioner*, 574 F.2d 694, 697-98

(2d Cir. 1978), *cert. denied*, 439 U.S. 859 (1978). However, this Court did not reject the *Donnan*, *Schlesinger* and *Hoeper* rationale in *Salfi*. Instead, the Court was careful to distinguish two cases that followed that rationale (*Stanley* and *LaFleur*) on the ground that *Salfi* involved merely a claim for a non-contractual government benefit. The Court also distinguished *Vlandis*, which like *Salfi*, did involve a government benefit program (in the form of reduced college tuition for instate residents) on the ground that, since the Connecticut statute tested its benefit by the factual question of residency, it could not at the same time deny to one seeking to meet the residency test the opportunity to show factors clearly bearing on that issue. Neither *Salfi* distinction is applicable in the instant case as (1) imposition of tax under the Internal Revenue Code is essentially the opposite of a claim for a non-contractual government benefit, and (2) Section 57(a)(6) and Treasury Regulations Section 1.57-1(f)(3), like the Connecticut statute in *Vlandis*, first makes a fact — fair market value — relevant in determining the measure of tax and then precludes the taxpayer from showing the effect of Section 16(b) on fair market value.

Even if the *Salfi* test of rational nexus between a statutory mandate and legitimate congressional purpose is applied to the facts of this case, the Treasury Regulations must still be found unconstitutional as applied. The congressional purpose in enacting the Section 83 standard for fair market value was to prevent the use of contractual restrictions on sale "designed to achieve deferral for tax savings purposes" H.R. Rpt. No. 91-413 (1969), 1969-3 C.B. 255. *See Sakol v. Commissioner*, 574 F.2d at 699. That is, Congress' legitimate purpose was to prevent the use of cooperatively imposed restrictions that were intended to provide a tax benefit to the employee rather than to advance purely employer purposes and that could be waived by the employer at will. *Id.* Although, arguably, there is a rational nexus

between this purpose and Section 83's fair market value in the case of contractual restrictions, the nexus breaks down in the case of the limitation on value imposed by Section 16(b) which is imposed by federal statute rather than by consensual contractual restrictions and as to which the employer has no practical power of waiver. More to the point, there is no suggestion in the legislative history underlying Sections 56 or 57 that Congress had a similar concern with tax avoidance schemes with respect to qualified stock options, nor does the clear language of Section 57(a)(6) suggest that Congress felt the need to ignore restrictions that adversely impacted fair market value in measuring the minimum tax. There is, in the end, no rational basis for dragging Petitioners into a net designed to defeat tax avoidance schemes totally unrelated to them, the employer or the statutorily imposed limitations on the fair market value of the stock received by them.

The tax statutes involved in *Donnan* and *Schlesinger* made the existence of a particular fact relevant to a determination of tax and then foreclosed the taking of evidence as to that fact. In a similar fashion, Section 57(a)(6) of the Internal Revenue Code makes the fair market value of stock relevant to a determination of minimum tax and Treasury Regulations Section 1.57-1(f)(3), by application of the limiting language of Section 83(a)(1), then bars the taxpayer from demonstrating the substantial adverse effect of Section 16(b) on fair market value. As in *Hoeper*, to the extent that minimum tax is imposed on a value that ignores the impact of Section 16(b) on Petitioners, it is imposed on an amount that has never been realized as an economic benefit by the Petitioners. The injustice and unfairness of this result is especially harsh in this case as the Petitioners could not have retained the NYSE Price had the stock been sold on the date acquired and in fact suffered a loss when they were

finally able to sell free of the Section 16(b) limitation. Under these circumstances, the application by Treasury Regulations Section 1.57-1(f)(3) of the Section 83(a)(1) fair market value standard to measure the minimum tax on Petitioners clearly violates the long standing constitutional principles enunciated in *Donnan*, *Schlesinger* and *Hoeper* and is unconstitutional.

Conclusion.

For the foregoing reasons, a Writ of Certiorari to the Court of Appeals for the Ninth Circuit should be granted.

Respectfully submitted,

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Attorneys for Petitioners,
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APPENDIX A.

Opinion of the United States Court of Appeals for the Ninth Circuit.

Aaron L. Kolom and Serita Kolom, Petitioners-Appellants, v. Commissioner of Internal Revenue, Respondent-Appellee. No. 79-7077.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted Dec. 4, 1980. Decided April 9, 1981.

Petition to Review a Decision of the Tax Court of the United States.

Before WALLACE, SKOPIL and REINHARDT, Circuit Judges.

WALLACE, Circuit Judge:

Aaron L. Kolom and Serita Kolom[1] appeal from a decision of the United States Tax Court determining a deficiency in their federal income tax for the taxable year 1972 in the amount of $43,792. The issue before us is whether restrictions placed upon the sale of stock by section 16(b) of the Securities Exchange Act of 1934 (the Act) affect the valuation of stock for purposes of asserting a minimum tax when stock options are exercised. We affirm.

I

During the taxable year 1972, Kolom was an officer and director of Tool Research and Engineering Corporation (Tool Research). Kolom had received options to purchase shares of Tool Research stock pursuant to an employees' stock option plan. The plan met the qualification requirements of sections 421 and 422 of the Internal Revenue Code

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[1]Serita Kolom is a party by reason of having filed a joint return with her husband.

of 1954 (the Code).[2] In 1972, Kolom exercised some of these options. The dates of exercise, the number of shares received, the mean price of the stock on the New York Stock Exchange on the date of exercise, and Kolom's option price were as follows:

Date of Exercise	Number of Shares	Mean Price Per Share on N.Y.S.E.	Option Price Per Share	Total Option Price
9/15/72	6,678	$52.00	$13.25	$88,464
10/5/72	4,174	45.25	12.00	50,088
10/5/72	1,575	45.25	19.625	30,909

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[2]Section 421. GENERAL RULES.

(a) EFFECT OF QUALIFYING TRANSFER.—If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 423(a), or 424(a) are met—

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

. . .

Section 422. QUALIFIED STOCK OPTIONS.

(a) IN GENERAL.—Subject to the provisions of subsection (c)(1), section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option if—

(1) no disposition of such share is made by such individual within the 3-year period beginning on the day after the day of the transfer of such share, and

(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

. . .

The stock received by Kolom could have been resold on the New York Stock Exchange at the price quoted above on the date the option was exercised. If Kolom had sold the stock on that date (or at any time within six months of that date), however, he would have been subject to the provisions of section 16(b) of the Act, 15 U.S.C. § 78p(b)[3] and he could have been required to give up any profit he made on such sales.

On September 15, 1972, when Kolom exercised the first of his options, the closing market price of Tool Research stock on the New York Stock Exchange was 51⅛. Six months later the mean price of the stock on the exchange was 23⅝. On October 5, 1972, when Kolom exercised his remaining options, Tool Research stock closed at 44. Six months later the mean price of the stock on the exchange was 20½.

When Kolom filed his income tax return for 1972, he completed and filed Form 4625, "Computation of Minimum Tax." Kolom showed tax preference items totaling $111,398, including accelerated depreciation and capital gains. The stock options, however, were not reflected in the minimum tax computation. On the last sheet of his return, Kolom included the following statement:

> Statement 9—Form 4625 Footnotes
>
> During 1972 taxpayer exercised his option to purchase Tool Research Co. stock. The taxpayer is not

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[3]Section 16(b) of the Securities Exchange Act of 1934 provides in part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer . . . .

15 U.S.C. § 78p(b).

treating this as preference income for the following reason:

> Income Tax Regulation 1.57-1(f)5(i) states that there is no tax preference if the stock is disposed of in the year the option is exercised. By law, the taxpayer could not sell the stock in the year the option was exercised because all of his profit would belong to the corporation. The stock is being sold the year in which the taxpayer is first able to sell the stock. Because of the above reason and because the nature of the tax consequences are the same whether the taxpayer sold the stock in the year the option was exercised or the succeeding year, the item is not being treated as a tax preference item in 1972.

Kolom's return for 1972 was examined and audit changes were made with respect to adjustments other than the minimum tax. He received a letter dated January 15, 1975, from the District Director stating that the revenue agent's report had been reviewed and accepted. Approximately a year later, Kolom received a telephone call from a revenue agent regarding his liability for minimum tax in 1972. After an examination of Tool Research's books and records, revenue agent Beal had submitted a written request for approval to reopen Kolom's 1972 tax liability. The reasons stated for the request were a "substantial error" and a "serious administrative omission resulting in criticism, undesirable precedent or inconsistent treatment." The request for reopening was approved, and Kolom was so notified in January 1976.

The Commissioner determined a deficiency of $42,489 on the basis of the imposition of the minimum tax on the aggregate amounts by which the fair market values of the shares of stock acquired pursuant to the qualified stock options exceeded their option prices on the dates of exercise. Subsequently, the Commissioner asserted an additional de-

ficiency of $1,303, making the total deficiency $43,792. This increased deficiency resulted from a recomputation of the market value-option price differential, on the basis of the mean price on the New York Stock Exchange on the date of exercise, rather than the closing price on the date of exercise.

On appeal, Kolom contends that (1) the Tax Court erred in determining that the bargain element of the options for the purpose of computing the minimum tax is the difference between the mean New York Stock Exchange price on the date of exercise and the option price without regard to section 16(b) profit restrictions, and (2) the Tax Court improperly concluded that Kolom was not subjected to an impermissible second examination in determining his 1972 tax deficiency.

II

This case deals primarily with the tax consequences of Kolom's exercise of stock options that qualify for special tax treatment provided in sections 421 and 422 of the Code. The Code provides that a qualified stock option may be granted to an individual in connection with this employment, enabling that employee to acquire stock of his employer at prices less than the market value of the stock, without resulting in a realization of taxable income to the employee either when the option is granted, or when it is exercised. As long as the taxpayer holds the shares of stock for at least three years and meets the other technical requirements, he will be taxed only when he ultimately sells or otherwise disposes of the shares of stock. At the time of disposition, the gain is taxed at favorable long-term capital gains rates. As a result, the "bargain element" of the option present at the time of exercise (the difference between the fair market value and the option price at the time of exercise) re-

ceives the same deferred capital gains treatment that the underlying shares receive.

Because many high income taxpayers could use the tax preference provisions to avoid significant tax liability, sections 56 and 57 of the Code were enacted.[4] These sections impose a minimum tax on taxpayers with large amounts of income from stock options, capital gains, and other sources receiving preferential tax treatment. Section 57(a)(6) states that there shall be included as an item of tax preference with respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option, "the amount by which the fair market value of the share at the time of exercise exceeds the option price." Thus, these sections impose a tax on a portion of the "bargain element" of the transaction.

The primary issue in this dispute is the method by which this bargain element subject to minimum taxation is to be determined. The parties disagree about the fair market value of the shares at the time Kolom exercised his option. Kolom

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[4]Section 56. IMPOSITION OF TAX.

(a) IN GENERAL.—In addition to the other taxes imposed by this chapter, there is hereby imposed for each taxable year, with respect to the income of every person, a tax equal to 10 percent of the amount (if any) by which—

(1) the sum of the items of tax preference in excess of $30,000, is greater than

(2) the sum of—

(A) the taxes imposed by this chapter for the taxable year . . . reduced by the sum of the credits allowable . . . [and]

(B) the tax carryovers to the taxable year. Section 57. ITEMS OF TAX PREFERENCE.

(a) IN GENERAL.—For purposes of this part, the items of tax preference are—

. . . . . .

(6) STOCK OPTIONS—With respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option (as defined in section 422(b)) or a restricted stock option (as defined in section 424(b)), the amount by which the fair market value of the share at the time of exercise exceeds the option price.

contends that section 16(b) of the Act is relevant to the determination of fair market value. As an officer and director of Tool Research, if Kolom had sold the stock within six months of the date he exercised the options, he could have been required to turn over any profits to Tool Research. He asserts, therefore, that the fair market value of the stock at the time of exercise was equal to the option price, because that is the amount he would have been able to retain if the stock had been sold on that day.

The Commissioner maintains, however, that the fair market value of the stock was its mean price on the New York Stock Exchange on the date of exercise. The Commissioner further contends that section 16(b) is totally irrelevant to the determination of fair market value for purposes of section 57(a)(6). For this argument, he relies upon Income Tax Regulation 1.57-1(f)(3) which states:

> In accordance with the principles of section 83(a)(1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined *without regard to restrictions* (other than nonlapse restrictions within the meaning of § 1.83-3(h)). Notwithstanding any valuation date given in section 83(a)(1), for purposes of this section, fair market value is determined as of the date the option is exercised.

(Emphasis added). Regulation 1.83-3(h) provides that "[l]imitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions." Thus, the Commissioner asserts that because section 16(b) is a limitation imposed by federal security law, section 16(b) does not affect the fair market value of the stock.

On appeal, Kolom advances three separate arguments with respect to the determination of fair market value. First, he argues that Income Tax Regulation 1.57-1(f)(3) is inconsistent with section 57(a)(6) as applied in this case because it applies section 83 to the qualified stock option section of the minimum tax provisions when section 83(e)(1) specifically prohibits the application of section 83 to stock acquired pursuant to a qualified stock option. Second, he asserts that the minimum tax imposed on the difference between the trading price of the stock and the option price on a taxpayer subject to section 16(b) is unconstitutional because it results in double taxation and income taxation on a transaction in which there has been an economic loss. Third, he contends that the long established definition of fair market value takes section 16(b) into account to satisfy the "willing seller" requirement of that definition.

A.

Kolom contends that regulation 1.57-1(f)(3), which uses the principles of section 83 to compute fair market value for purposes of the minimum tax, is inconsistent with the section 83(e)(1) express exclusion of section 421 stock. Under section 83, the acquisition of stock in connection with the performance of services is subject to tax in the amount of the difference between the fair market value of the stock, "determined without regard to any restriction other than a restriction which by its terms will never lapse," and the amount paid for the stock by the taxpayer. I.R.C. § 83(a)(1). Section 83(e) states that "[t]his section shall not apply to . . . a transaction to which section 421 applies . . . ." Kolom argues that sections 56 and 57 do not state that section 83 or any of the regulations thereunder shall apply to section 57. Only the Treasury Regulations, which are established thereunder shall apply to section 57. Only

the Treasury Regulations, which are established by the Commissioner and not by the Congress, mention the applicability of section 83. Therefore, he argues, section 83 and all the regulations thereunder do not apply to qualified stock options. He further contends that regulation 1.57-1(f)(3), as it relates to section 83, is inconsistent with section 57(a)(6) as it applies to qualified stock options and, therefore, it is invalid.

Kolom has attempted to show the invalidity of regulation 1.57-1(f)(3) by examining the legislative history of section 83. He argues that Congress intended section 83 to govern restricted stock plans but not qualified stock option plans like the one involved in the instant case.[5] Although we find that the legislative history of section 83 does indicate a Congressional intent to attach different tax benefits to restricted stock plans than to qualified stock option plans, we have been unable to find any Congressional intent to distinguish between the plans with respect to the method by which fair market value is to be determined. We agree with the Tax Court that:

> [t]he regulations do not provide for inclusion in a taxpayer's taxable income of the value of the stock received upon exercise of a qualified stock option. Rather, the regulations apply the valuation principles of section 83 in determining the fair market value of stock received by a taxpayer upon exercise of a qualified stock option. Therefore, we see no merit in petitioners' assertion that section 1.57-1(f)(3) of the reg-

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[5]Qualified stock option plans are generally considered a means to provide employees with a stake in the business, whereas restricted stock plans are considered merely deferred compensation arrangements. Senate Committee on Finance, Tax Reform Act of 1969, S.Rep. No.552, 91st Cong., 1st Sess. 120 (1969), U.S. Code Cong. & Admin. News 1969, 1645.

> ulations is invalid because of an inconsistency with section 83(e)(1).

Kolom v. Commissioner, 71 T.C. 235, 241 (1978). Regulation 1.57-1(f)(3) does not have any effect upon qualified stock option plans from the standpoint of income taxation. Rather, the regulation merely defines the bargain realized by the taxpayer upon the exercise of the qualified stock option, in order to subject that bargain to an entirely different tax treatment, the minimum tax. *Harrison v. United States*, 475 F.Supp. 408, 412 (E.D. Pa. 1979).

B.

Kolom further contends that the minimum tax is unconstitutional as applied in the instant case, because it results in double taxation and income taxation on a transaction in which he has suffered an economic loss. He argues that when a taxpayer is subject to section 16(b), the minimum tax is imposed on a gain that cannot be realized until at least six months after the date of exercise. the gain realized, therefore, cannot be recognized until the ultimate disposition of the stock. He alleges that a mere deferral of a realized gain, which could be completely eliminated by a decline in the value of the stock before the time of sale, is not income and therefore should not be subject to taxation.

In response to Kolom's argument, the Tax Court found that:

> [t]he flaw in this argument is that a gain is realized upon exercise of the option itself. At that time petitioner acquired property the value of which substantially exceeded the price paid for the property. Were a gain not realized at this time, the nonrecognition provisions of sections 421 and 422 would be superfluous. *See Commissioner v. LoBue*, 351 U.S. 243 [76 S.Ct. 800, 100 L.Ed. 1142] (1956); *Commissioner v. Smith*, 324 U.S. 177 [65 S.Ct. 591, 89 L.Ed. 830] (1945). It is true that

> within the 6-month period following exercise of the options, petitioner may not be able to reduce his realized gain to cash without disgorging part or all of the profit to the corporation. It is also true that a decline in market value during the 6-month period in which the provisions of section 16(b), Securities Exchange Act of 1934 are applicable could eliminate any gain on the sale of the stock during that period. That risk, however, is one the petitioner assumed when he chose to exercise the stock options. It does not follow, however, that merely because petitioner could not reduce his gain to cash for 6 months without incurring a section 16(b) liability, he had no gain.

Kolom v. Commissioner, supra, 71 T.C. at 250.

We agree with the Tax Court that at the time Kolom exercised the option he did realize an economic benefit. Kolom himself testified that he could have pledged the stock as collateral against a loan based upon the fair market value of the stock on the New York Stock Exchange. In addition, Kolom received other rights incident to ownership of the stock, such as voting rights and the right to receive dividends, *See Sakol v. Commissioner*, 574 F.2d 694, 700 (2d Cir.) *cert. denied*, 439 U.S. 859, 99 S.Ct. 177, 58 L.Ed.2d 168 (1978).

Although we have never addressed this issue, the Second Circuit has rejected a claim similar to Kolom's that the valuation of stock without regard to a temporary restriction is constitutionally improper. In *Sakol v. Commissioner, supra*, the court upheld the constitutional validity of subjecting a taxpayer of restricted stock to income taxation without regard to the temporary impact the restrictions would have on the value of the stock. The court found that the rule of section 83(a) that temporary restriction should be ignored for valuation purposes might appear arbitrary but

that ". . . a workable, practical system of taxing employees' restricted stock options can overlook, at least temporarily, a speculative decrease in value in ascertaining the amount of compensation received in the form of restricted stock where the employee has obtained both voting power and dividend rights." *Id.* at 700 (footnotes omitted). The court went on to state:

> Congress is not required to take each and every restriction into account in combating tax-avoidance, or to make equally difficult individual evaluations which depend upon the parties' subjective intentions. Rather, the Sixteenth, and Fifth, Amendments permit the line drawn to be a rough one, in the interest of realistically solving a practical problem . . . .

Id. We are convinced that the valuation principles involved in the instant case in computing the minimum tax require the same types of lines to be drawn as the valuation principles involved in *Sakol* required. Accordingly, we find that the minimum tax is not unconstitutional as applied to a taxpayer subject to section 16(b).

C.

Kolom's final challenge to the determination of fair market value is that the established definition of fair market value includes the notion of a willing seller, and that as a result of the section 16(b) restriction on the stock, Kolom could not have been a willing seller. Fair market value has been defined as " 'the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.' " *United States v. Cartwright*, 411 U.S. 546, 551, 93 S.Ct. 1713, 1716, 36 L.Ed.2d 528 (1973), *quoting* Treas. Reg. §20.2031-1(b). The Tax Court decided that the willing

buyer/willing seller test does not refer to Kolom's own unwillingness to sell under the particular circumstances of his case. Rather, the test concerns hypothetical buyers and sellers in the market place. *See Estate of Reynolds v. Commissioner*, 55 T.C. 172, 195 (1970). We are persuaded by the Commissioner's argument that Kolom's unwillingness to sell his stock on the date he exercised the options is irrelevant to the determination of fair market value.

Kolom has attempted to support his contention that section 16(b) operates as an exception to the use of the quoted market price as fair market value by relying upon cases in which the owner of the stock was actually restricted from selling or transferring the property on the open market. *Mailloux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963) (agreement that required the approval of the principal promoter before sale); *Cohu v. Commissioner*, 8 T.C. 796 (1947) (shares could not be sold without written consent of Commissioner of Corporations); *Goldwasser v. Commissioner*, 47 B.T.A. 445 (1942), *aff'd*, 142 F.2d 556 (2d Cir.), *cert. denied*, 323 U.S. 765, 65 S.Ct. 119, 89 L.Ed. 612 (1944) (contract provision requiring no public offering of stock). These cases all involve situations in which the owner could not legally dispose of the stock. The case before us is different: the stock was freely tradeable on the market at the market price. We are therefore not persuaded that these cases support Kolom's position.

Kolom also attempts to show that section 16(b) liability is to be an adjustment to the listed price of the stock in determining the fair market value by relying upon *Cummings v. Commissioner*, 506 F.2d 449 (2d Cir. 1974), *cert. denied*, 421 U.S. 913, 95 S.Ct. 1571, 43 L.Ed.2d 779 (1975); *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973); and *MacDonald v. Commissioner*, 230 F.2d 534 (7th Cir. 1956). Both *Anderson* and *Cummings* involved the question

of the tax treatment of the disgorging of profits required by section 16(b). We agree with the Commissioner that these cases are not helpful. Here Kolom never had any 16(b) liability because he did not sell or dispose of any of the stock within the six month period following the exercise of the options.

In *MacDonald v. Commissioner, supra*, the taxpayer had exercised an option to purchase stock of the corporation of which he was an officer and director. The court found that the stock options exercised by the taxpayer had been granted with the intent of compensating the taxpayer for services to be rendered, and that, therefore, the taxpayer had received compensation income at the time of the exercise of the stock options. The case was remanded to the Tax Court, however, for a reconsideration of the proper formula for determining the amount of compensation income realized by the taxpayer, in light of the effect of section 16(b) and the taxpayer's agreement not to sell the stock. *MacDonald v. Commissioner, supra*, 230 F.2d at 5 40-41. The court specifically stated that it was not deciding whether section 16(b) had an effect on the fair market value of the stock at the time the option was exercised. *Id.* at 540. Any statements in the opinion concerning the effect of 16(b) on the market value of the shares are therefore dicta. Nevertheless, we are unpersuaded by the *MacDonald* court's statement that:

> [N]either the taxpayer nor any other person under similar circumstances would be a willing seller, with knowledge that all profits realized might inure to the benefit of the corporation, and it is doubtful if any person cognizant of the circumstances would become a willing buyer.

Id. at 541. As we have said, although we recognize that section 16(b) may have discouraged Kolom from selling his stock, it would have no demonstrable effect upon the market

value of the shares. Section 16(b) affects only the seller's ability to keep the profits after disposing of the stock, not the marketability of the stock itself.

III

Kolom also argues that the deficiency asserted by the Commissioner resulted from a prohibited second examination of his books and records under section 7605(b) of the Code.[6] The Tax Court found that the reopening of Kolom's case had not resulted from a second examination of his books and records. In fact, no second examination had ever taken place. The reopening instead resulted from an examination of the books and records of Tool Research. On appeal, Kolom now argues that there was an oral agreement between the Internal Revenue Service (IRS) and Kolom on the original audit of his tax return, and that this agreement precludes the IRS from reopening his case.

Section 7121 of the Code provides for binding closing agreements between the IRS and a taxpayer with respect to any taxable liability.[7] Section 7121, however, requires a

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[6]Section 7605(b) provides:

> (b) RESTRICTIONS ON EXAMINATION OF TAXPAYER — No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

(Emphasis added).

[7]Section 7121 provides in part:

> CLOSING AGREEMENTS.
>
> (a) AUTHORIZATION. — The Secretary or his delegate is authorized to enter into an agreement *in writing* with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

(footnote continued on following page)

written closing agreement authorized or approved by the Secretary. We have no evidence of such a written agreement in this case. Section 7122 of the Code allows for the IRS to compromise any case prior to referring the case to the Department of Justice for prosecution or defense. Treasury Regulation 301.7122-1(d)(3) provides that such an offer to compromise shall be accepted only when the taxpayer is notified in writing. We find no such evidence of notification in the instant case. The audit report sent by the revenue agent to Kolom contained no mention of any such closing agreement or offer to compromise. As a result we find the reopening of Kolom's case was not prohibited.

Affirmed.

(b) FINALITY. — If such agreement is approved by the Secretary or his delegate (within such time as may be stated in such agreement, or later agreed to) such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact —

(1) The case shall not be reopened as to matters agreed upon. . . .

(Emphasis added).

APPENDIX B.

Opinion of the United States Tax Court.

Aaron L. Kolom and Serita Kolom, Petitioners, vs. Commissioner of Internal Revenue, Respondent.

November 21, 1978

S. Zachary Samuels, for the petitioners. *Kenneth G. Gordon*, for the respondent.

Scott, *Judge*: Respondent determined a deficiency of $42,489 in petitioners' Federal income tax for the calendar year 1972. By amendment to answer, respondent claimed an increased deficiency of $1,303, making the total deficiency in issue $43,792. The increased deficiency resulted from a recomputation of income subject to the minimum tax based on the mean price of stock with respect to which options were exercised rather than the closing price on the New York Stock Exchange. The increased deficiency is not an issue separate from the issues with respect to the deficiency as determined in the notice of deficiency.

The issues presented for decision are:

(1) What is the fair market value of stock acquired by petitioner Aaron L. Kolom pursuant to his exercise of qualified stock options;

(2) Whether the minimum tax provisions of sections 56 and 57(a)(6), I.R.C. 1954,[1] are unconstitutional as applied to the facts of this case;

(3) Whether the deficiency was determined as a result of a second examination of petitioners' records; and

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

(4) Whether respondent should be required to pay petitioners' attorney's fees incurred in connection with this case.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners Aaron L. Kolom and Serita Kolom, husband and wife, resided in Los Angeles, Calif., at the time they filed the petition in this case. They timely filed their Federal income tax return for the calendar year 1972. Petitioners signed their 1972 return on April 5, 1973.

During the year 1972, Aaron L. Kolom (hereinafter petitioner) was an officer and director of Tool Research & Engineering Corp. (hereinafter Tool Research), a corporation duly formed and organized under the laws of the State of Delaware. As of 1972, Tool Research was a corporation registered under section 12, Securities Exchange Act of 1934, 15 U.S.C. sec. 78*l*.

On November 6, 1968, Tool Research's Stock Option Committee, pursuant to the employees' stock option plan which met the qualification requirements of section 422, granted petitioner an option to purchase 2,000 shares of $1 par value Tool Research capital stock at an option price of $44 per share. The option continued for a term of 5 years, and was exercisable in whole or in part in installments of 25 percent at the time the option was granted, 25 percent at the end of the first year, 25 percent at the end of the second year, and the final 25 percent at the end of the third year. If petitioner did not exercise the full 25 percent in any one year, his rights the following years were to be cumulative. In accordance with the terms of Tool Research's Employees' Stock Option Plan, the option could not be exercised more than 5 years from the date of the grant

thereof. In addition, the option could not be exercised if there were outstanding any qualified stock option granted before the grant of the option of November 6, 1968. On February 23, 1970, petitioner was granted an additional option for the purchase of 5,000 shares of Tool Research stock at an option price of $13,375 per share. On January 29, 1971, petitioner was granted another option for the purchase of 3,000 shares of Tool Research stock at an option price of $20.625 per share. The terms of these latter two options were substantially the same as the terms of the option granted petitioner on November 6, 1968.

In 1972, petitioner exercised certain qualified stock options he had in Tool Research's qualified stock option plan. The dates of the exercise, the numbers of shares received, the mean price of the stock on the New York Stock Exchange on the date of exercise, and petitioner's option price were as follows:[2]

Date of exercise	*Number of shares*	*Mean price per share on N.Y.S.E.*	*Option price per share*	*Total option price*
9/15/72	6,678	$52.00	$13.25	$88,484
10/5/72	4,174	45.25	12.00	50,088
10/5/72	1,575	45.25	19.625	30,909

The stock received by petitioner was registered under Form S(8) of the applicable Securities and Exchange Regulations. The stock could have been resold on the New York Stock Exchange at the price quoted at the time of sale on the date the option was exercised but had it been sold on that date petitioner, as a director and officer of Tool Research, would

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[2]Because of stock splits and stock dividends, the number of shares subject to options was increased and the per share price decreased. The options which were exercised were the three options referred to in the findings.

have been subject to the provisions of section 16(b), Securities Exchange Act of 1934, 15 U.S.C. sec 78p(b).[3]

On September 15, 1972, when petitioner exercised the first of his options, the closing market price of Tool Research stock on the New York Stock Exchange was 51⅛ upon the expiration of 6 months, the stock closed at 23⅝. On October 5, 1972, when petitioner exercised his remaining options, Tool Research stock closed at 44; 6 months later the stock closed at 20⅜. From March 15, 1972, to September 15, 1972, the lowest price of Tool Research stock on the New York Stock Exchange was 41. The price did not go below 40 during the calendar year 1972. In January 1973, the lowest price to which the stock dropped was 32 and in February, 24. The price at which the stock closed on April 5, 1973, was the lowest price the stock had reached up to that time during the year 1973.

With his income tax form for 1972, petitioner completed and filed Form 4625, "Computation of Minimum Tax." This form shows tax-preference items totaling $111,398, which consist of accelerated depreciation and capital gains. Petitioner's stock options are not reflected in the minimum tax computation. On the last sheet attached to his tax return, however, petitioner included the following statement:

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[3]Under the terms of sec. 16(b), Securities Exchange Act of 1934, the profits realized by an officer or director of a corporation from the sale of an equity security of that corporation within 6 months after its acquisition inure to the benefit of, and are recoverable by, the corporation. Generally, the measurement of the sec. 16(b) liability is the difference between the price at which the shares were acquired and the sales price. Under reg. 16(b)-5, Securities and Exchange Commission, 17 C.F.R. sec. 240.16b-6 (1977), however, when a stock option is exercised more than 6 months after it was granted, the sec. 16(b) liability is subject to a maximum limit, measured by the difference between the sales price and the lowest quoted market price within 6 months before and after the date of exercise of the option.

Statement 9-Form 4625 Footnotes

During 1972 taxpayer exercised his option to purchase Tool Research Co. stock. The taxpayer is not treating this as preference income for the following reason:

Income Tax Regulation 1.57-1(f)5(i) states that there is no tax preference if the stock is disposed of in the year the option is exercised. By law, taxpayer could not sell the stock in the year the option was exercised because all of his profit would belong to the corporation. The stock is being sold the year in which the taxpayer is first able to sell the stock. Because of the above reason and because the nature of the tax consequences are the same whether the taxpayer sold the stock in the year the option was exercised or the succeeding year, the item is not being treated as a tax preference item in 1972.

Petitioner's return for 1972 was examined and audit changes were made with respect to adjustments other than the minimum tax. Petitioner and respondent agreed to these adjustments in November 1974. Subsequent to petitioner's meeting with the revenue agent regarding his tax liability, petitioner received a letter dated January 15, 1975, from the District Director stating that the revenue agent's report had been reviewed and accepted. Approximately a year later, petitioner received a phone call from a revenue agent who brought up the subject of petitioner's liability for minimum tax in 1972. Petitioner gave the agent no information above and beyond that which had been considered during the course of the audit. As a result of an examination of Tool Research's books and records, in September of 1975, Revenue Agent Lloyd E. Beal submitted a written request for approval to reopen petitioner's 1972 tax liability, a closed examined case. The reasons for the request were a "substantial error" and a "serious administrative omission resulting in criticism, undesirable precedent or inconsistent

treatment." The reopening memorandum was approved by Mr. Beal's group supervisor, the chief of the field audit branch, the acting technical coordinator, the acting chief of the audit division, and the acting district director. The approval to reopen petitioners' examined year was obtained in October 1975 and petitioners were so notified in January 1976.

On petitioners' Federal income tax return for 1973, they showed a minimum tax liability of $8,097 for stock options. This figure was apparently calculated on the basis of the difference between the option price of the stock and the mean prices at which the stock was traded 6 months after the date of exercise.

In his notice of deficiency, respondent determined the $424,888 difference between the fair market value of the stock at the time of exercise of the options and the option price to be an item of tax preference subject to the minimum tax.

OPINION

Section 56(a)[4] as applicable to the year 1972 imposed a tax of 10 percent of the amount by which items of tax preference in excess of $30,000 were greater than the sum

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[4]Sec. 56(a), as effective in 1972, provided:

SEC. 56. IMPOSITION OF TAX.

(a) In General. — In addition to the other taxes imposed by this chapter, there is hereby imposed for each taxable year, with respect to the income of every person, a tax equal to 10 percent of the amount (if any) by which —

(1) the sum of the items of tax preference in excess of $30,000, is greater than

(2) the sum of —

(A) the taxes imposed by this chapter for the taxable year (computed without regard to this part and without regard to the taxes imposed by sections 531 and 541) reduced by the sum of the credits allowable under —

(i) section 33 (relating to foreign tax credit),

(ii) section 37 (relating to retirement income),

(iii) section 38 (relating to investment credit),

(iv) section 40 (relating to expenses of work incentive program), and

(v) section 41 (relating to contributions to candidates for public office); and

(B) the tax carryovers to the taxable year.

of the income tax for the year computed without regard to the tax imposed by section 56(a) and certain other sections and reduced by certain specified credits. The items of tax preference to which the minimum tax applies are set forth in section 57. Where stock is transferred pursuant to the exercise of a qualified or restricted stock option, under section 57(a)(6)[5] the amount by which the fair market value of the stock at the date of exercise of the option exceeds the option price is a tax-preference item.

Respondent contends that the amount of the item of tax preference subject to the minimum tax is, under section 57(a)(6), the mean price of the stock on the New York Stock Exchange on the day of the exercise of each option less the amount paid for, *i.e.*, the option price of, the stock.

Petitioners argue that the fair market value of the stock Mr. Kolom received upon the exercise of his options does not exceed the option price and, therefore, he had no item of tax preference. Petitioners' argument is that had Mr. Kolom sold the stock on the day he exercised the option or within 6 months thereafter, his profit would have inured to the benefit of the corporation under section 16(b), Securities Exchange Act of 1934, and for this reason the option price of the stock constitutes its fair market value. Petitioners argue that, if section 57(a)(6) is not construed as they contend, it is unconstitutional.

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[5]Sec. 57(a)(6) provides:

SEC. 57. ITEMS OF TAX PREFERENCE.

(a) In General. — For purposes of this part, the items of tax preference are —

* * * * * * *

(6) Stock Options. — With respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option (as defined in section 422(b)) or a restricted stock option (as defined in section 424(b)), the amount by which the fair market value of the share at the time of exercise exceeds the option price.

In support of his position that the fair market value of the stock is its mean listed price on the New York Stock Exchange on the dates the options were exercised, respondent relies on section 1.57-1(f)(2)-(3)[6] Income Tax Regs. At the time of the trial in this case, the regulations with respect to the minimum tax were in proposed form. They have since been adopted, T.D. 7564, 43 Fed. Reg. 40459 (Sept. 12, 1978). While there are some differences in language in the proposed and final regulations, the substance of the provisions with respect to the applicability of the minimum tax to the exercise of qualified or restricted stock options is the same. Section 1.57-1(f)(3), Income Tax Regs., provides that the fair market value of stock received upon the exercise of a qualified stock option is to be determined in accordance with the principles of section 83(a)(1) without regard to restrictions other than nonlapse restrictions within the meaning of section 1.83-3(h), Income Tax Regs. Petitioners contend that section 1.57-1(f)(3), Income Tax Regs., is invalid. They base this contention pri-

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[6]Sec. 1.57-1(f)(2)-3, Income Tax Regs., provides:

(f) *Stock options*, * * *

(2) *Definitions*. See generally sec. 1.421-7(e), (f), and (g) for the definitions of "option price," "exercise," and "transfer," respectively; however, in the case of a transfer of a share of stock pursuant to the exercise of a qualified stock option or a restricted stock option after the death of an employee by the estate of the decedent (or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent), the term "option price" shall, for purposes of this paragraph, include both the consideration paid by the estate (or such person) for such share of stock and so much of the basis of the option as is attributable to such share of stock. * * *

(3) *Fair market value*. In accordance with the principles of section 83(a)(1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of sec. 1.83-3(h)). Notwithstanding any valuation date given in section 83(a)(1), for purposes of this section, fair market value is determined as of the date the option is exercised.

marily on the ground that this regulation is contrary to section 83(e)(1), which provides that section 83 is inapplicable to section 421 transfers. The regulations do not provide for inclusion in a taxpayers's taxable income of the value of the stock received upon exercise of a qualified stock option. Rather, the regulations apply the valuation principles of section 83 in determining the fair market value of stock received by a taxpayer upon exercise of a qualified stock option. Therefore, we see no merit in petitioners' assertion that section 1.57-1(f)(3), Income Tax Regs., is invalid because of an inconsistency with section 83(e)(1). The balance of petitioners' argument as to the invalidity of section 1.57-1(f)(3), Income Tax Regs., deals primarily with the applicability of certain of the provisions of section 83(a)(1) and section 1.83-3(h), Income Tax Regs., to this case, rather than with the validity of the regulations.

Section 83(a) generally provides that when property is transferred to a taxpayer in connection with the performance of services, the value of the property at the first time the rights of the taxpayer in the property are transferable or not subject to a substantial risk of forfeiture, less the amount paid for the property, is includable in the taxpayer's gross income. Under section 83(a)(1)[7] the value of the property is to be determined without regard to restrictions other than those which, by their terms, will never lapse. Section 1.83-

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[7]SEC. 83. PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) General Rule. — If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier,

* * *

3(h),[8] Income Tax Regs., provides that a "nonlapse restriction" is a permanent limitation on the transferability of property which applies to the transferee or any subsequent holder. This regulation states that limitations imposed by registration requirements of State or Federal securities laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. Respondent contends that section 16(b) of the Securities Exchange Act of 1934 is not a "nonlapse restriction" within the meaning of section 1.83-3(h), Income Tax Regs. Petitioners contend that section 16(b), Securities Exchange Act of 1934, is not a registration requirement or a similar law and conclude that the regulations are for this reason invalid as applied to this case. While petitioners' argument, if accepted, would go to the applicability of the regulations to this case, it does not go to the validity of the regulations.

If section 16(b), Securities Exchange Act of 1934, is a "restriction" as that term is used in section 83(a)(1) and section 1.83-3(h), Income Tax Regs., it clearly is not a "nonlapse restriction" within the meaning of those regu-

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[8]Sec. 1.83-3(h), Income Tax Regs., provides:

(h) *Nonlapse restriction.* For purposes of section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property —

(i) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and

(ii) Which will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).

A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent nonlapse restriction. Limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. An obligation to resell or to offer to sell property transferred in connection with the performance of services to a specific person or persons at its fair market value at the time of such sale is not a nonlapse restriction. See sec. 1.83-5(c) for examples of nonlapse restrictions.

lations since under section 16(b), Securities Exchange Act of 1934, the requirement of payment to the corporation of profits upon sale of the stock expires 6 months after exercise of the stock option.

While not specifically so stated, petitioners apparently contend that respondent's regulations as applied to this case are invalid since they change preexisting law as to the determination of the fair market value of stock received upon the exercise of qualified stock options by a taxpayer subject to the provisions of section 16(b), Securities Exchange Act of 1934. In our view, for reasons hereinafter stated, without reference to section 1.57-1(f)(2)-(3), Income Tax Regs., the law is that the fair market value of stock received by a taxpayer subject to section 16(b), Securities Exchange Act, is its selling price on the New York Stock Exchange when it is received. Therefore, section 1.57-1(f)(2)-(3), Income Tax Regs., if applicable, is not invalid as applied to this case. We express no opinion as to whether this regulation would be valid in a situation in which it changed the criteria for determining the fair market value of stock from that under existing law.

The provisions of section 57(a)(6) refer to "the fair market value" of the stock which is the subject of the exercise of the qualified stock option at the date of the exercise of the option. When Congress enacted this section, the term "fair market value" had long had a clearly defined meaning, *United States v. Cartwright*, 411 U.S. 546, 551 (1973).

Generally, where stock is traded on a national exchange, the fair market value of relatively small quantities of the stock on any date on which the stock is traded on that exchange is the price at which the stock is sold. *United States v. Cartwright, supra; Freshman v. Commissioner*, 33 B.T.A. 394, 402-403 (1935). The obvious reason for using the exchange price as the fair market value of the

stock is that this price is the best evidence of what a willing buyer will pay a willing seller for the stock. However, there are many exceptions to the use of the quoted exchange prices as indicative of the value of stock. These cases all involve unusual circumstances such as a restriction on sale of the stock or a large block of stock being valued. *Frizzelle Farms, Inc. v. Commissioner*, 61 T.C. 737, 743 (1974), affd. 511 F.2d 1009 (4th Cir. 1975).

Applying the ordinary rules of determining the fair market value of the number of shares of stock involved in each transaction in this case, the mean price at which the stock sold on the New York Stock Exchange on the date of the transaction would be the fair market value of the stock. If the stock had actually been sold, petitioners recognize that the New York Stock Exchange price would have been the price which would have been received for the stock. Petitioners nevertheless contend that under the facts of this case that amount is not the "fair market value" of the stock within the meaning of section 57(a)(6).

Both parties agree that fair market value is "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy nor to sell and both being informed." *United States v. Cartwright, supra; Hamm v. Commissioner*, 325 F.2d 934, 937 (8th Cir. 1963), affg. a Memorandum Opinion of this Court. Petitioners argue that in this case on of the necesary elements, a willing seller, is missing. This argument is not new. We have consistently held that the definition is not a personalized one which envisions a particular seller and a particular buyer. Rather, the definition refers to hypothetical parties. As we said in *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970):

> "Fair market value" is not an incantation whose ritualistic use will immediately reveal the worth of

> unusual types of property. The basis of the definition of fair market value is the assumption that hypothetical willing buyer and hypothetical willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts, will arrive at some sale price for the property in question. * * * In reality, no willing buyers or willing sellers may exits. * * * [55 T.C. at 195.]

Petitioners argue that even though as a general rule the willing buyer and willing seller may be hypothetical, under the circumstances of this case the price to the seller at which the property would change hands in any sale transaction is the option price, because this is the amount that Mr. Kolom would be permitted to retain, after paying his liability under section 16(b), Securities Exchange Act of 1934.[9] They cite *Anderson v. Commissioner*, 480 F.2d 1304 (7th Cir. 1973), revg. 56 T.C. 1370 (1971); *Cummings v. Commissioner*, 506 F.2d 449 (2d Cir. 1974), revg. 61 T.C. 1 (1973); and *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974), for the proposition that section 16(b) payments are properly

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[9]Petitioner may have been able to retain part of the profits upon sale since it appears that reg. 16b-6, Securities and Exchange Commission, 17 C.F.R. sec. 240.16b-6 (1977), is applicable. This regulation provides:

Sec. 240.16b-6 Exemption of long term profits incident to sales within six months of the exercise of an option.

(a) To the extent specified in paragraph (b) of this section the Commission hereby exempts as not comprehended within the purposes of section 16(b) of the act any transaction or transactions involving the purchase and sale or sale and purchase of any equity security where such purchase is pursuant to the exercise of an option or similar right either (1) acquired more than six months before its exercise, or (2) acquired pursuant to the terms of an employment contract entered into more than six months before its exercise.

(b) In respect of transactions specified in paragraph (a) of this section the profits inuring to the issuer shall not exceed the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale. Nothing in this section shall be deemed to enlarge the amount of profit which would inure to the issuer in the absence of this section.

characterized as adjustments to the purchase price of stock and that the sales price or market price should be reduced by the amount of any potential section 16(b) liability. *Kimbell v. United States, supra,* did not involve the sale of "insider" stock although cases involving this issue were discussed therein (490 F.2d at 205). At issue in each of the other two cases was whether section 16(b) repayments to a corporation by an insider who had sold stock should be characterized as ordinary and necessary business expenses or as capital losses. In these cases, it was held that the *Arrowsmith*[10] doctrine applied and the section 16(b) repayments constituted capital losses. It is true that in these cases the courts characterize the section 16(b) repayments as effectively being adjustments to the sales price of the stock sold. However, this characterization was for the purposes of showing the application of the *Arrowsmith* doctrine and the relationship between the sales transaction and the payment of the section 16(b) liability. In our view these cases do not hold, as petitioners argue, that the fair market value of the stock is to be reduced by the potential section 16(b) liability. Demonstrative of this fact is that in *Cummings v. Commissioner, supra,* the sale resulting in the capital gain was in the year preceding the 16(b) repayment. No adjustment was made to the gain in the prior year. The repayment in the subsequent year was considered a capital loss in the year in which made even though because of other capital losses it resulted in no tax benefit in that year to the taxpayer. In our view the cases dealing with the treatment of section 16(b) repayments are not helpful in resolving the issue presented in this case of the fair market values of the stock when the options were exercised.

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[10]*Arrowsmith v. Commissioner,* 344 U.S. 6 (1952).

Petitioners strongly rely on *MacDonald v. Commissioner*, 230 F.2d 534 (7th Cir. 1956), affg. in part and revg. in part 23 T.C. 227 (1954). In *MacDonald*, to induce a taxpayer to accept employment, a corporation granted him stock options exercisable at less than the stock's market value. This Court held that upon exercise of the options, the bargain element — the spread between the option price of the stock and its fair market value — was compensatory in nature and therefore includable in the taxpayer's gross income. This conclusion was sustained on appeal. This Court, however, had also held that the measure of the fair market value of the stock was its selling price on the New York Stock Exchange. In so concluding we did not recognize as binding an oral agreement restricting the sale of the stock. The Court of Appeals for the Seventh Circuit reversed this issue on the ground that a restrictive agreement between the taxpayer and the corporation prohibiting sale of the stock during the course of the taxpayer's employment did exist and affected the stock's fair market value. After reaching this conclusion the Court further stated:

> We think that for our present purpose we are not required to decide whether Sec. 16(b) is applicable. The many cases cited in U.S.C.A. following the section disclose that it has been a fruitful source of litigation and that it has been given a liberal interpretation.
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> It is true that the section does not preclude the sale of stock. As stated in Consolidated Engineering Corp. v. Nesbit, D.C., 102 F.Supp. 112, 114:
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> "It will be noted from the above that Section 78p does not make the purchase and sale of stock unlawful or irregular. It provides only that the profits, if any, shall be recovered by the corporation."

The statute, however, does make the seller liable for profits realized from such sale. * * *

* * * * * * *

Even though we find it unnecessary to decide the question, we are strongly inclined to the view that the statute is applicable and that if the taxpayer had sold the stock during the six-month period following its acquisition, he would have been liable to account to the corporation for all profits. And it can be said to a certainty that if he had done so he would have laid himself open to an action for the recovery of such profits, with the probability that he could not have defended successfully. * * *

* * * Taxpayer acquired the corporate stock with an agreement not to sell and, in addition, if he had violated this agreement and sold the stock, he probably would have been required to account for the profits. Certainly he would have been faced with a legal action to recover such profits. This is not to say that he did not realize economic gain upon purchase of the stock but, even so, the question remains as to the proper formula for the ascertainment of the amount and extent of such gain. The Tax Court has held that it is the difference between the option price and the fair market value of the stock on the New York Stock Exchange at the time of its acquirement. We disagree with that conclusion. * * *

The testimony of these expert witnesses clearly shows that neither the taxpayer nor any other person under similar circumstances would be a willing seller, with knowledge that all profits realized might inure to the benefit of the corporation, and it is doubtful if any person cognizant of the circumstances would become a willing buyer. [230 F.2d 540-541]

It is to be noted that the *MacDonald* case involved stock options granted to the taxpayer as compensation. The state-

ments of the Circuit Court of Appeals as to the applicability of section 16(b), of the Securities Exchange Act, were dicta. However, the statements themselves show that the Circuit Court did not contemplate that because of the provisions of section 16(b), Securities Exchange Act, the option price represented fair market value.[11]

In *Husted v. Commissioner*, 47 T.C. 664, 679 (1967), we held stock acquired by the taxpayer for less than its fair market value represented additional compensation. The taxpayer had paid $1 a share for most of the stock and $3 a share for the remainder. Although small quantities of this stock had been sold near the valuation date at $11 a share, we concluded that the fair market value of the stock on the date of its acquisition was $7. In reaching this conclusion we stated at page 679.[12]

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[11]After the remand in *MacDonald v. Commissioner*, 230 F.2d 534 (7th Cir. 1956), affg. in part and revg. in part 23 T.C. 227 (1954), respondent moved for a further hearing pursuant to the mandate of the Court of Appeals and proposed alternative methods of computing the gain realized by the taxpayer. Unable to find any meritorious method of computation other than that used in the original opinion, i.e., the difference between the option price and the market price of the stock as traded on the New York Stock Exchange, this Court denied respondent's motion. *MacDonald v. Commissioner*, a Memorandum Sur Order dated Oct. 18, 1956. An appeal was taken from our decision of no deficiency thereafter entered. This decision of no deficiency was reversed and the case was remanded by the United States Court of Appeals for the Seventh Circuit with instructions to hear additional evidence. *Commissioner v. MacDonald*, 248 F.2d 552 (7th Cir. 1957).

[12]In *Burns v. Commissioner*, T.C. Memo. 1974-220, we stated as follows, with respect to *Husted v. Commissioner*, 47 T.C. 664, 679 (1967):

Although no restrictions were noted on the face of the certificate received by the taxpayer in *Husted*, as is also true of the immediate case, disposition of the stock was significantly restricted by the following factors not found here: (1) the taxpayer executed an "investment letter" for each block of shares in which he warranted to Dorsey that he was acquiring the stock for investment and "without any intention of selling or distributing the same"; (2) the 4,200 shares were subject to a repurchase agreement in favor of Dorsey in the event the acquisition was not completed; (3) taxpayer's stock represented a significant portion of the outstanding stock of Dorsey and exceeded the amount of Dorsey stock sold on the exchange in each of the six months following the acquisition; and (4) there was a possibility that the taxpayer's resale of the stock within six months of receipt could have violated section 16(b) of the Securities and Exchange Act of 1934.

> We have examined all the circumstances surrounding Husted's stock holding. Although the investment letter, as a practical matter, prevented Husted from selling the stock publicly for some period of time. it did not prevent him from selling the stock privately. *Victorson v. Commissioner*, 326 F.2d 264 (C.A. 2, 1964), affirming a Memorandum Opinion of this Court; *Jack I. LeVant*, 45 T.C. 185 (1965), on appeal (C.A. 7, May 18, 1966). Thus, Husted's situation differed from that in the case of *Harold H. Kuchman*, 18 T.C. 154 (1952), acq. 1952-2 C.B. 2. Because of his position with Dorsey, section 16(b) of the Securities and Exchange Act of 1934 (48 Stat. 881, 896) might apply to any sale of the stock which he would make within 6 months of its acquisition. [Footnote omitted.] Although there is some legal uncertainty as to the applicability of section 16(b) in this situation, it is enough for us to recognize that the possibility of its applying constituted a deterrent to the sale of the stock within 6 months. Husted's holding of 34,200 shares represented a significant portion of the outstanding stock and exceeded the amount of stock sold on the exchange in April or in any of the other 6 succeeding months. However, we know that 150,000 shares were sold through the underwriting in the last part of April and the first part of May; and though there would no doubt be some difficulty in finding a placement for another 34,000 shares, we are inclined to think that it would not have been impossible. * * *

In the *Husted* case, as above stated, we determined that the fair market value of the large block of restricted stock was $7 a share, greatly in excess of the price the taxpayer paid for the stock on the date the stock was acquired.

In arguing that the value of stock held by an insider is limited to the price paid for the stock because of a potential

section 16(b) liability, petitioners quote out of context language from *Bayley v. Commissioner*, 69 T.C. 234 (1977), a Court-reviewed case. The full statement from which that language is extracted is —

> We do not believe that Rev. Rul. 68-286 is contrary to our decision in *Hirsch* since we believe it was based on the premise that section 16(b) restrictions do not "significantly" affect value rather than that the section 16(b) restrictions are not "restrictions" within the meaning of the applicable regulations. A buyer (unless he, too, is an "insider") will take an "insider's" stock free from the restrictions of section 16(b) *so that such restrictions do not affect the value of such stock in the eyes of the purchaser. The value of such stock to the selling "insider" will be reduced, not because its market value is reduced, but only because he must return any "insider profit" to his company.* * * * [69 T.C. at 244; emphasis added.]

This language does not lend support to petitioners' argument but rather recognizes that section 16(b) does not affect market value, even though it might affect the value to the insider of the stock held by the insider.

Petitioner's argument that the "fair market value" of the stock Mr. Kolom received on the exercise of his stock options as of the date the options were exercised was the option price is tantamount to an argument that sections 56 and 57(a)(6) do not apply to a person subject to the provisions of section 16(b), Securities Exchange Act[13] Since many

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[13]The legislative history is clear that the tax imposed by sec. 56 was intended to require the payment of some tax on "economic income" which under the tax laws was not "taxable income." However, there is no discussion specifically of the intent of sec. 57(a)(6) which was added to the House bill by the Senate. See H. Rept. 91-413 (1969), 1969-3 C.B. 200, 249; S.Rept. 91-552 (1969), 1969-3 C.B. 423, 495; Conf. Rept. 91-782 (1969), 1969-3 C.B. 644, 658, 659.

participants in qualified stock option plans are "insiders" subject to section 16(b) of the Securities Exchange Act, had Congress intended so drastic a limitation of the application of the sections, in our view the statute would have so stated.

Since in our view Congress did intend sections 56 and 57(a)(6) to apply to persons subject to the provisions of section 16(b), Securities Exchange Act, we do not accept petitioners' argument that the fair market value of the stock for which Mr. Kolom exercised his stock options in 1972 at the date of the exercise of those options was the option price of the stock.

Petitioners on brief argue that even if their primary argument is not accepted, some adjustment to the value of their stock must be made because of the provisions of section 16(b), Securities Exchange Act. Petitioners suggest that we should use the market price of the stock on the date 6 months following Mr. Kolom's purchase of the stock. There is no support for this position in the statute.[14] Section 57(a)(6) refers to fair market value at the date the option is exercised. There is nothing in this record to show that section 16(b) was a restriction which had a significant effect on the value of the stock Mr. Kolom received when he exercised his option under our holding of what constitutes "fair market value" in *Bayley v. Commissioner, supra.*

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[14] It should be noted that at the time the option is exercised there is no way to determine whether the market price of the stock on the stock exchange will increase or decrease in the ensuing 6 months. All that can be known at that time is the value at dates prior to the exercise of the option. This leaves as speculative whether an "insider" subject to the provisions of sec. 16(b), Securities Exchange Act, who has held his option for over 6 months at the time it is exercised would, even if he sold the stock within 6 months, be liable to return to the corporation any amount in excess of the price he received and the lowest price of the stock in the 6 months prior to the date of the exercise of the option. (See nn. 3 & 9 *supra*)

In our view, if we adhere to our holding in the *Bayley* case we must conclude here that since section 16(b) does not affect the value of the stock in the eyes of the purchaser no adjustment is required to the quoted price of the stock on the dates on which Mr. Kolom exercised his options because of the provisions of section 16(b), Securities Exchange Act.

We therefore hold that respondent properly computed the fair market value of the stocks here involved by use of the mean prices at which those stocks sold on the New York Stock Exchange on the dates Mr. Kolom exercised his options.

Petitioners' second argument is that the minimum tax provisions of sections 56(a) and 57(a)(6) are unconstitutionally confiscatory as applied to the exercise of a qualified stock option by a person subject to section 16(b), Securities Exchange Act of 1934.

The thrust of petitioners' argument in this regard is that a market decline during the 6-month period following exercise of the option could eliminate any profit Mr. Kolom could have realized upon the sale of the stock acquired upon exercise of the option. Accordingly, his argument continues, the minimum tax may be imposed in the absence of any realized gain. The flaw in this argument is that a gain is realized upon exercise of the option itself. At that time, petitioner acquired property the value of which substantially exceeded the price paid for the property. Were a gain not realized at this time, the nonrecognition provisions of sections 421 and 422 would be superfluous. See *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945). It is true that within the 6-month period following exercise of the options, petitioner may not be able to reduce his realized gain to cash without disgorging part or all of the profit to the corporation. It is also true that

a decline in market value during the 6-month period in which the provisions of section 16(b), Securities Exchange Act of 1934, are applicable could eliminate any gain on the sale of the stock during that period. That risk, however, is one that petitioner assumed when he chose to exercise the stock options. It does not follow, however, that merely because petitioner could not reduce his gain to cash for 6 months without incurring a section 16(b) liability, he had no gain. In fact, he had the very type of "economic income," which because of the provisions of sections 421 and 422 is not "taxable income," to which sections 56 and 57 are directed. See n. 13 *supra*. Had petitioner sold his stock in 1972, and 1973 been required by section 16(b), Securities Exchange Act, to pay over all or part of his profit to the corporation, he would have had a gain on the sale in 1972 and an expense deduction or loss from the payment in 1973, *Cummings v. Commissioner, supra*.

Petitioner's final argument is that he was subject to a prohibited second examination in contravention of section 7605(b)[15] There was no prohibited second examination in this case. The examination resulting in the deficiency in petitioners' minimum tax involved no examination of petitioners' books and records. Rather, it occurred after an examination of Tool Research's books and records. It was made with approval of the auditing employee's supervisors and involved only a telephone conversation with petitioner. Also, petitioner was notified of the reopening of his taxable year 1972. With regard to the purposes underlying the en-

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[15]SEC. 7605. TIME AND PLACE OF EXAMINATION.

(b) Restrictions on Examination of Taxpayer. — No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

actment of section 7605(b), this Court said in *Collins v. Commissioner*, 61 T.C. 693, 698-699 (1974):

> It is evident from the legislative history of section 7605(b) that Congress intended that provision to prevent the Internal Revenue Service from undertaking repetitive investigations as a method of taxpayer harrassment. There is no indication that it was enacted to restrict the scope of the Commissioner's legitimate power to protect the revenue. * * *

We hold that there was no prohibited second examination of petitioners' books and records under section 7605.

As we held in *Key Buick Co. v. Commissioner*, 68 T.C. 178 (1977), this Court is without jurisdiction to award attorney's fees to petitioners.

Decision will be entered for the respondent.

Reviewed by the Court.

Hall, *J.*: I concur in the result.

A share of stock awarded as compensation to a person who is subject to a legal requirement that he must disgorge any gains on a sale thereof within 6 months obviously provides significantly less compensation to him than would an otherwise identical share awarded to a person not so subject. Such differences in value may be ignored under section 83 for transactions within its scope, but section 83(e)(1) forbids respondent from applying section 83 to transactions, such as this, covered under section 421. Hence section 1.57-1(f)(3), Income Tax Regs., overreaches in defying this prohibition. It cannot be reconciled with the statute and, in my view, is invalid. Section 57(a)(6) defines as the tax preference the excess of "fair market value" over the option price. The statute nowhere authorizes respondent to use, as he does, a figure clearly in excess of fair market value. On the other hand, petitioner is clearly wrong in arguing that

either his option price, or the price 6 months later, was fair market value. Since he failed to show the true fair market value of the restricted shares, and there is no evidence in the record to show it, we have no choice but to sustain respondent.

Drennen, *J.*, agrees with this concurring opinion.

APPENDIX C.

United States Constitution — Amendment V.

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

APPENDIX D.

Internal Revenue Code Section 56(a).

(a) General Rule. — In addition to the other taxes imposed by this chapter, there is hereby imposed for each taxable year, with respect to the income of every person, a tax equal to 15 percent of the amount by which the sum of the items of tax preference exceeds the greater of —

(1) $10,000, or

(2) the regular tax deduction for the taxable year (as determined under subsection (c)).

APPENDIX E.

Internal Revenue Code Section 57(a)(6).

(a) In General. — For purposes of this part, the items of tax preference are —

(6) Stock options. — With respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option (as defined in section 422(b)) or a restricted stock option (as defined in section 424(b)), the amount by which the fair market value of the share at the time of exercise exceeds the option price.

APPENDIX F.

Internal Revenue Code Section 83(a).

(a) General Rule. — If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

APPENDIX G.

Internal Revenue Code Section 83(e).

(e) Applicability of Section. — This section shall not apply to —

(1) a transaction to which section 421 applies,

(2) a transfer to or from a trust described in section 401(a) or a transfer under an annuity plan which meets the requirements of section 404(a)(2),

(3) the transfer of an option without a readily ascertainable fair market value, or

(4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant.

APPENDIX H.

Internal Revenue Code Section 421(a).

(a) Effect of Qualifying Transfer. — If a share is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 423(a), or 424(a) are met —

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporation for the share so transferred.

APPENDIX I.

Internal Revenue Code Section 422(a).

(a) In General.—Subject to the provisions of subsection (c)(1), section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option if—

(1) no disposition of such share is made by such individual within the 3-year period beginning on the day after the day of the transfer of such share, and

(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

APPENDIX J.

Proposed Treasury Regulation Section 1.57(f)(3), as Proposed December 30, 1970.

(f) Stock options —

(3) *Fair market value*. The fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined as of the date of the exercise of the option and consistent with the principles applicable under section 83(a)(1) and the regulations thereunder.

APPENDIX K.

Treasury Regulations Section 1.57-1(f)(3), as Adopted in Final Form September 11, 1978.

(f) *Stock options* —

(3) *Fair market value*. In accordance with the principles of section 83(a) (1), the fair market value of a share of stock received pursuant to the exercise of a qualified or restricted stock option is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of §1.83-3(h)). Notwithstanding any valuation date given in section 83(a)(1), for purposes of this section, fair market value is determined as of the date the option is exercised.

APPENDIX L.

Treasury Regulations Section 1.83-3(h).

(h) *Nonlapse restriction.* For purposes of section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property —

(i) Which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and

(ii) Which will continue to apply to an be enforced against the transferee or any subsequent holder (other than the transferor).

A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent nonlapse restriction. Limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. An obligation to resell or to offer to sell property transferred in connection with the performance of services to a specific person or persons at its fair market value at the time of such sale is not a nonlapse restriction. See §1.83-5(c) for examples of nonlapse restrictions.

APPENDIX M.

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78p(b).

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

APPENDIX N.

Rule 16b-6; 17 C.F.R. 240.16b-6.

(a) To the extent specified in paragraph (b) of this rule, the Commission hereby exempts as not comprehended within the purposes of Section 16(b) of the Act any transaction or transactions involving the purchase and sale, or sale and purchase of any equity security where such purchase is pursuant to the exercise of an option or similar right either (1) acquired more than six months before its exercise, or (2) acquired pursuant to the terms of an employment contract entered into more than six months before its exercise.

(b) In respect of transactions specified in paragraph (a) the profits inuring to the issuer shall not exceed the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale. Nothing in this rule shall be deemed to enlarge the amount of profit which would inure to the issuer in the absence of this rule.

(c) The Commission also hereby exempts, as not comprehended within the purposes of Section 16(b) of the Act, the disposition of a security, purchased in a transaction specified in paragraph (a), pursuant to a plan or agreement for merger or consolidation, or reclassification of the issuers' securities, or for the exchange of its securities for the securities of another person which has acquired its assets, or which is in control as defined in Section 368(c) of the Internal Revenue Code of 1954, of a person which has acquired its assets, where the terms of such plan or agreement are binding upon all stockholders of the issuer except to the extent that dissenting stockholders may be entitled, under statutory provisions or provisions contained in the certificate of incorporation, to receive the appraised or fair value of their holdings. [Added by Release No. 34-5004,

February 25, 1954, 19 F. R. 1174; amended by Release No. 34-7717 (¶77,291), October 1, 1965, 30 F. R. 12772.]

(d) The exemptions provided by this rule shall not apply to any transaction made unlawful by Section 16(c) of the Act or by any rules and regulations thereunder.

(e) The burden of establishing market price of a security for the purpose of this rule shall rest upon the person claiming the exemption.

(f) The exemption granted pursuant to this rule shall apply to any liability under Section 16(b) existing at or after the effective date of this rule but shall not be deemed to affect judgments rendered prior to that date.

[Adopted in Release No. 34-4509. November 29, 1950, 15 F. R. 7357; amended by Release No. 34-5004. February 25, 1954, 19 F. R. 1174; and by Release No. 34-7717 (¶77,291), October 1, 1965, 30 F. R. 12772.]